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ORIGINS OF INFLATIONARY EXPECTATIONS

by

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ORIGINS OF INFLATIONARY EXPECTATIONS

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Inflation is one economic fact of life of which consumers are well aware. In the May 1979 Survey of Consumer Attitudes, conducted by the Survey Research Center at The University of Michigan, 91 percent of all families expected prices to increase during the next year. Almost 70 percent of all consumers expected prices to increase by five percent or more, and 45 percent of all families expected prices to increase by ten percent or more. On average consumers expected prices to increase by 11.4 percent in May 1979, up from 8.2 percent in May 1978. This represents the highest mean expected price increase ever recorded in these surveys. Only in one previous quarter (November 1974) did the average expected price increase exceed ten percent. Moreover, the May 1979 reading is the second consecutive quarterly reading above ten percent.

The overriding concern among consumers with inflation has also been expressed by the frequency with which inflation is named both as the number one problem facing the nation as well as the number one problem facing individual families. The heightened concern with inflation during the past year has lead to the bleakest business and personal financial outlooks ever recorded in the 30-year history of these surveys.

Expectations of inflation have varied considerably over time--see Chart 1. Throughout the 1950's, the average expected price increase recorded in these surveys remained below two percent per year. In the early sixties, expected price increases ranged form two to three percent. From mid-1972 to late 1974, the average expected price increase rose from 3.04 percent to 10.66 percent. Recent increases have also been sharp: in the fourth quarter of 1976 consumers expected prices to increase on average by just 4.8 percent, less than half of the 11.4 percent recorded in mid-1979.

Basis of Expectations

Changes in expectations are systematic and based on reality. Price expectations need to be accurate if they are to serve the best interests of decision makers, in this case the consumers; consequently, they are revised with feedback from learning and from changed circumstances. Without exploring a more formal model, the most immediate past experiences with price changes are often found to have a large influence on expected future change. This close association between time-series changes in price expectations and the current quarterly rate of change in the C.P.I. is shown in Chart 2. The time-series correlation of price expectations with quarterly C.P.I. changes was 0.89.

When consumers were directly asked which price increases made them most aware of inflation in mid-1978, the vast majority mentioned that they were most aware of food price increases (Table 1). The number of respondents reporting awareness of food price changes greatly exceeded any other mention. In comparison to the 89 percent who mentioned food prices, just 26 percent, the next highest in frequency, mentioned price changes for clothing. Somewhat more than one-in-ten respondents mentioned being most aware of price changes for fuel, utilities, housing and autos. Less than one-in-twenty consumers mentioned that medical costs or appliances had made them most aware of inflation.

A similar question was asked in late 1978, and provides a partial assessment of the accuracy of these expectations. Respondents were asked which prices had increased the most during the past twelve months (Table 2). In response, one-in-four respondents mentioned the cost of food (28 percent), and another one-in-four mentioned the cost of housing (26 percent). Medical costs and utilities were each mentioned by approximately 17 percent as having increased in price the most during the past year. Few respondents indicated the price of clothing or appliances had increased greatly during the past twelve months.

These perceptions of price increases were compared to the actual C.P.I. change during the year prior to the survey. Food prices were most frequently identified by respondents as having increased the most, and also recorded the highest actual C.P.I. change. In fact, the rank order of items according to respondent perceptions and actual C.P.I. change was identical, except for appliances (Table 2).

Causes of Inflation

Consumers not only look toward past price changes when assessing expected future changes, they also incorporate more broadly based indicators. For example, an OPEC price announcement or the settlement of a labor contract indicates increasing prices even before they are registered in the market place. To assess which general areas consumers look toward, respondents to the March 1979 survey were asked to state, in their own words, why they thought prices had gone up as much as they have over the past couple of years. In response, steep wage increases were mentioned by 29 percent, excessive government spending by 14 percent, and excessive business profits by 16 percent (Table 3). In addition, one-in-four consumers mentioned the impact of higher food and energy prices on the economy. A few consumers mentioned balance of payment problems (7 percent), high production costs/low productivity (7 percent), and consumers buying too much (5 percent).

Following this unprompted free-response question, respondents were asked to rate the importance of several different potential causes of inflation (Table 4). In response, three-in-four consumers stated that energy price increases had a great deal to do with the increased rate of inflation. In addition, 71 percent of all families reported that government overspending had a great deal to do with the increased rate of inflation, and 62 percent felt that the government printed too much money without anything to back it up.

Overall, government policy and energy prices were the two most frequently mentioned causes of inflation. Nonetheless, half of all households also mentioned business firms raising prices too much, and half mentioned workers who received large wage increases as having a great impact on inflation. Just one-in-three felt high interest rates or consumers buying too much had a great impact on inflation. Interestingly, although government spending programs were in general criticized by the majority, just 29 percent reported that government programs to reduce unemployment had a great deal to do with inflation.

Cures for Inflation

Fully one-in-three respondents in the March 1979 survey felt there was little or nothing anyone could do about inflation, and consequently felt that we had to live with inflation as best we could. The majority, however, felt something could be done to reduce inflation (Table 5). When asked what could be done, consumers mentioned wage and price controls (30 percent), cutting government spending (8 percent), and decreasing imports (7 percent). Interestingly, 13 percent of all respondents mentioned consumers should economize and conserve to reduce inflation, and another 14 percent mentioned that government controls should be reduced.

When asked who was responsible for taking action to reduce inflation, Congress was singled out more frequently (23 percent) than the President or Executive Branch (17 percent). Together, these branches of government were mentioned more than twice as frequently as consumers, business, or unions.

In the April 1979 survey, consumers were questioned as to whether they thought wage and price controls would be helpful in reducing inflation (Table 6). In response, 30 percent of all respondents felt controls would be helpful in comparison with 43 percent who judged controls to be not helpful.

This distribution of responses is similar to that obtained in early 1974, also a time of rapid price increases. In the intervening years, somewhat more households reported controls as helpful (24 to 30 percent), and somewhat fewer households reported controls as not helpful (56 to 43 percent). Nonetheless, at each time respondents more frequently judge controls as not helpful rather than helpful in reducing inflation.

Moreover, even if wage and price controls were in place, and all incomes were automatically adjusted to keep pace with inflation, the majority of Americans would still be concerned with inflation (Table 7). When asked in April 1979, 54 percent of all respondents said that even if their incomes were indexed to keep pace with inflation they would nonetheless be concerned with inflation. Forty-two percent stated that with such indexation, they would no longer be concerned with inflation. Respondents frequently mentioned they would still be concerned with inflation because they felt indexation would be unfair or poorly administrated, or only make inflation worse. This pattern of responses is identical to the one obtained earlier in August 1974.

Summary and Discussion

Consumer expectations about aggregate changes in the rate of inflation closely correspond to actual changes in the C.P.I. Perceptions of differential price increases among several broad categories of products also proved accurate when compared to actual changes. Expectations are reality based in that they not only reflect what has happened in the past, they also incorporate people's best estimates of future change. What people believe to be the major causes or sources of inflationary pressures point toward the early warning indicators used by consumers. Among the many sources mentioned by consumers, the common theme was the unchecked and excessive actions on the part of big business and big unions, as well as big government. Excessive wage increases, soaring profits, and government deficits were each as likely to be singled out as the primary cause of inflation.

Just as no single cause of inflation dominated consumer opinions, there was no widely preferred remedy for inflation either. There was greater consensus, however, in the belief that the government bore the major responsibility to take action to reduce inflation. This mandate is anchored on underlying root causes, since many consumers found price and wage controls and even full indexation of incomes not sufficient to end their concern with inflation.

Public policies aimed at breaking the momentum of inflationary psychology must take these findings into account. The most direct and reliable method of reducing price expectations is through actual reductions in the current rate of price increases. Public policy is then properly directed toward reducing inflation, not the symptoms that high inflation generates. It has been often argued, however, that a sudden and dramatic change is required to break the psychology of inflation, even apart from any actual change in prices. Policy aimed at public persuasion that the future will improve, despite currently worsening inflation, can be successful only insofar as actual future rates of inflation decline. Given the strong reality basis of inflationary expectations, consumers will continue to judge the credibility of economic policy against unfolding economic events, and revise expectations accordingly.

Because inflation by its very nature increases uncertainty and fear among consumers, government economic policy should act as a source of stability and security. Confidence in government economic policy provides the necessary atmosphere to place temporary economic reversals in perspective. Moderation of price expectations can only be facilitated by confidence and trust; distrust can only exacerbate expected changes.

Attempts to reduce inflationary expectations to be persuasive must not only be factual, but also helpful to consumers. Since much of the recent inflation has involved steep price increases in food, housing, and transportation, the necessary changes and adjustments in consumptive life styles are extensive. Much

of the costs of disruption could be avoided if public policy promoted confidence and a sense of equal burden sharing when making these adjustments. Consequently, public policy would be better served if rather than simply trying to break the psychology of inflation, consumers were also advised on how to best reduce the costs of their adjustment to the prevailing higher rates of inflation.

CHART 1

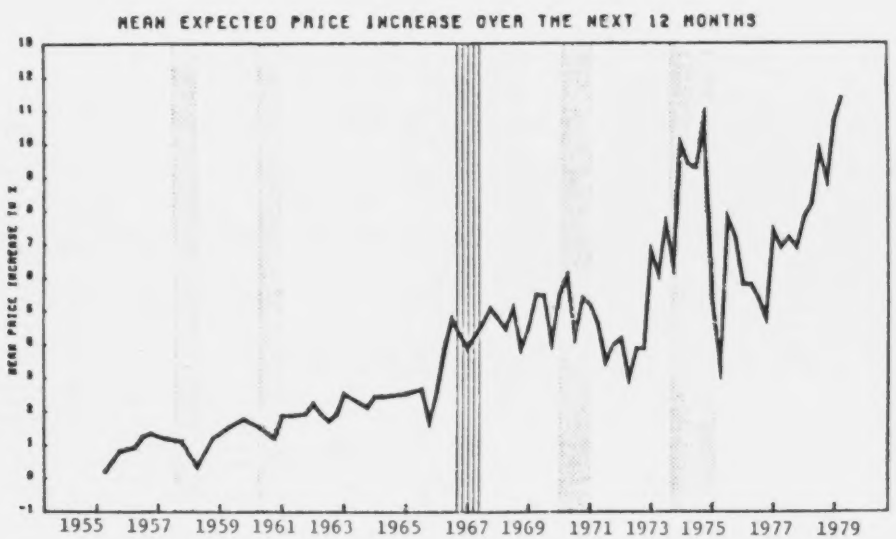
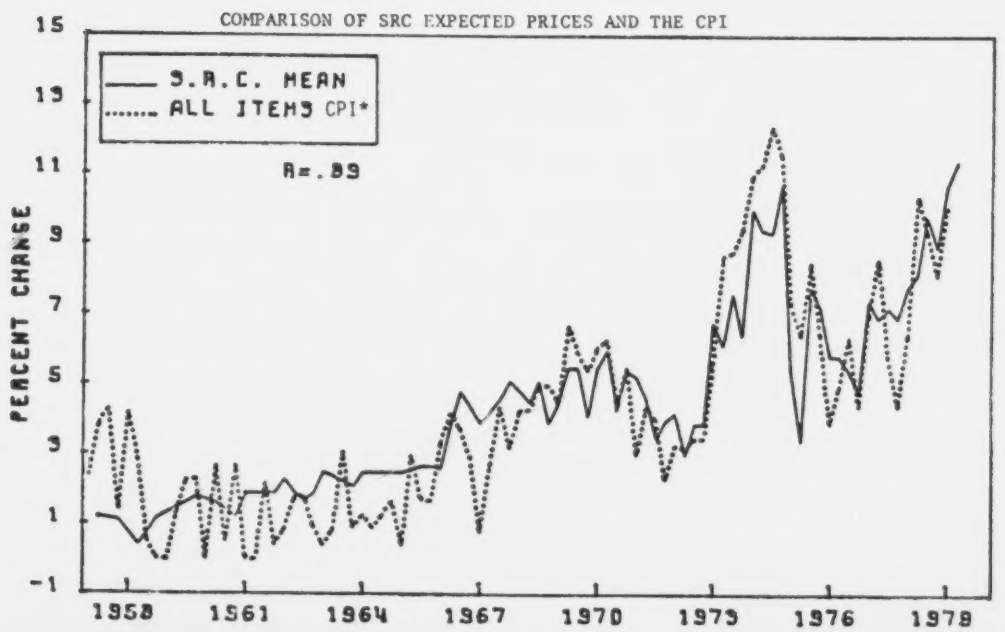


CHART 2



*Quarterly change at annual rates

TABLE 1

Price Increases Which Made Consumers Most Aware of Inflation

(May 1978 Survey)

	First Mention	Second Mention	Third Mention	All Mentions
Food	76%	11%	2%	89%
Clothing	3	19	4	26
Fuel	3	6	5	14
Utilities	4	6	3	13
Autos	2	6	4	12
Housing	3	4	4	11
Medical	*	2	2	4
Appliances	1	2	1	4
Other items	6	4	2	12
DK;NA	2	40	73	
Total	100%	100%	100%	
Cases	1,298	1,298	1,298	

*Less than 0.5 percent

The question was: Which price increases during the past few months have made you most aware of inflation? Anything else?

TABLE 2

Consumer Reports of the
Largest Price Increases During the Past Year

(November 1978 Survey)

Item	During the Past Twelve Months ... Greatest Price Increase was in ...	Price Increase of Item was Among Three Highest	Actual Change in CPI (Oct.1977-Oct.1978)
Food	28%	86%	12.2
Housing	26	48	11.8
Medical	17	48	8.4
Utilities	16	50	6.4
Automobile	7	30	6.3
Clothing	3	30	3.9
Appliances	*	4	8.4
DK;NA	3	-	-
Total	100%	-	-
Cases	1,460	-	-

*Less than 0.5 percent.

The question was: We would like to have your opinion on which price increases have been largest during the last year. After I have read the following list, please tell me which three items you think have gone up the most in price during the last year: a) food, b) clothing, c) utilities, d) housing, e) medical costs, f) automobiles, g) appliances. Of the three which one do you think has shown the greatest price increase?

TABLE 3

Consumer Opinions on the Major Causes of Inflation

(March 1979)

Causes of Inflation	First Mention	Second Mention	Total Mentions
Government			
Spending programs	11%	3%	14%
Balance of payments	6	1	7
Too many controls	1	*	1
More controls needed	2	*	2
Business			
High profits	9	7	16
High production costs	3	3	6
Low productivity	1	*	1
Consumer			
Union wage demands	8	2	10
Other wage increases	15	4	19
Consumers buying too much	4	1	5
Product Areas			
Food	6	3	9
Energy	9	7	16
Other Reasons	12	3	15
Don't know; not ascertained	13	-	-
No second mention	-	66	-
TOTAL	100%	100%	121%[a]
Cases	769	769	769

[a]Adds to more than 100% due to multiple mentions

The question was: Why do you think prices have gone up as much as they have over the past couple of years?

TABLE 4

Consumer Opinions on Several Possible Causes of Recent Inflation

(March 1979)

Causes of Inflation	Increased the Rate of Inflation a ... Great Deal	Somewhat	A Little	Not at All	DK;NA	Total
Oil, energy prices	74%	18%	6%	*	2%	100%
Gov't overspending	71	17	7	2%	3	100%
Govt' printing too much money	62	18	9	4	7	100%
Business firms raising prices	51	34	13	1	1	100%
Large wage increases	50	29	14	3	4	100%
High interest rates	37	42	16	3	2	100%
Consumers buying too much	33	30	23	11	3	100%
Gov't programs to reduce unemployment	29	35	20	10	6	100%

*Less than 0.5 percent. Cases = 769.

The questions were: There may have been several causes of inflation during the past couple of years. For each of the following statements, please tell me whether you think this has increased inflation a great deal, somewhat, a little, or not at all: a) Some business firms have raised prices to increase their profits; b) Some groups received wage increases that were too large; c) The cost of oil and other kinds of energy in producing food and other products; d) The government in Washington spending more money than it took in; e) Increases in the interest rates that banks charge for loans, f) People buying products they don't really need; g) The government in Washington printing money with nothing to back it up; h) The government spending money to keep down unemployment.

TABLE 5

Consumer Opinions on What Can Be Done About Inflation

(March 1979)

What can be Done about Inflation?		
Have to live with inflation	36	
Something can be done	61	
What can be done?[a]		
Controls on wages, prices & profits		30
Cut Government spending		8
Decrease imports		7
Consumers economize & conserve		13
Reduce Government controls		14
Who is responsible for taking action?[a]		
President		17
Congress		23
Business		9
Consumers		13
Unions		4
DK;NA	3	
Total	100%	
Cases	769	

[a]Adds to more than 61% due to multiple mentions.

The questions were: Do you think something can be done about the problem of rising prices, or is it just a problem we'll have to live with? What do you think can be done about rising prices? Who do you think is most responsible for doing something about inflation?

TABLE 6

Consumer Opinions on Whether Wage and
Price Controls Would Be Helpful in Reducing Inflation

	February 1974	April 1979
Helpful	24	30
Helpful in some ways, not helpful in other ways	12	19
Not helpful	56	43
DK;NA	8	8
Total	100%	100%
Cases	1,233	962

The question was: Some people think that mandatory government wage and price controls help to reduce inflation; other people think that mandatory wage and price controls are not very helpful in reducing inflation. What do you think?

TABLE 7

Concern with Inflation If All Incomes Were Indexed

If incomes were adjusted for inflation, would people still be concerned with inflation?	August 1974	April 1979
Yes	54	54
No	42	42
DK;NA	4	4
Total	100%	100%
Cases	1,309	962

The question was: If everyone could be sure that their income would be adjusted to keep up with the rate of inflation, do you think people would still be concerned about inflation?

APPENDIX TABLE A

Consumer Opinions About Inflation

(August 1977)

In the past few years, prices have gone up faster than in early 1970s or 1960s because...	Agree	Pro-Con	Disagree	DK;NA	Total	Most Important Reason
Business firms raising prices	77%	2%	15%	6%	100%	23%
Labor union wage increases	70	2	22	6	100%	31
Government spent too much	59	4	30	7	100%	27
Shortages of Consumer goods	37	2	57	4	100%	11
Government did not tax enough	8	1	83	8	100%	*

To slow down inflation, the Government should...	Agree	Pro-Con	Disagree	DK;NA	Total	Most Important Remedy
Encourage more employment	82%	2%	14%	2%	100%	44%
Decrease Government spending	65	2	25	8	100%	24
Wage and Price Controls	49	3	45	3	100%	21
Ration scarce goods	32	4	58	6	100%	3
Raise income taxes	9	2	86	3	100%	2

*Less than one-half of one percent.

The questions were: During the past several years prices have gone up faster than in the early 1970's and 1960's. Do you agree or disagree with the following reasons why this might have happened: a) Prices have gone up faster because the government did not tax enough; b) Prices have gone up faster because business firms have raised prices too much; c) Prices have gone up faster because of short supplies of the things consumers need; d) Prices have gone up faster because of short supplies of the things consumers need; e) Prices have gone up faster because the government spent too much? Next, I'll read a list of things which some people say should be done to slow down inflation. First--do you agree or disagree that a) the government should encourage more employment to slow down inflation; b) the goverment should spend less to slow down inflation; c) the government should raise income taxes to slow down inflation; d) the government should control wages and prices to slow down inflation; e) the government should ration scarce goods to slow down inflation.